



Monetary policy decision: reduction in bank rate

- We believe that the cycle of easing will continue, and expect a reduction of 25 bp in the reference rate. We think that there is a margin for implementing a more aggressive policy of monetary easing which could reduce the bank rate by 50 bp between this and the next few meetings. However, in its most recent communication, Banxico gave signs that although it wanted to continue to reduce the interest rate, it would be at a more moderate pace and with an eye on the inflationary pressures derived from exchange-rate depreciation. Thus although it has the margin to lower it more aggressively, we believe that the Central Bank will adjust the lending rate by only 25 bp.
- In recent months we have argued that the recent pressures on the Mexican currency are the result of the global aversion arising from the international financial tensions and economic perspectives, mainly in the U.S. In other words, we believe that to a large extent the interest rate differential with the U.S. is not an influence on the depreciation of the peso, which is not directly linked to the monetary strategy of the Bank of Mexico. In fact, the differential has remained at very high levels of an average of 800 bp since the currency began to weaken in September 2008. The determinants of the exchange rate respond to global factors, and their impact has not been limited by the continuing high differential. In normal conditions, this differential would have been translated into an appreciation of the peso.
- The recent exchange-rate intervention measures announced by the Exchange Rate Commission will prevent a sudden lack of dollar liquidity, and help mitigate the potential pressure on the exchange rate, although it will not guarantee that there will be none. This week we have seen a rally in global markets that has had a positive effect on the currencies of emerging economies. The Mexican peso has appreciated by 4.36%. In other words, it once more formed part of the underlying global aversion, but this time positively. The strong overreaction of the peso in recent months, and its level of undervaluation, leads to us considering that there should be a greater appreciation in the medium term, particularly if market feeling changes. In other words, if markets anticipate that the solution to the financial crisis is not far away. In the short term we could continue to experience volatility and sudden changes in market sentiment, but it is a fact that any sustained appreciation of the peso would be triggered by global factors.
- The exchange-rate depreciation has had an effect on the prices of goods, and in general, on the underlying rate of inflation. The above limits the expected range of action from Banxico, and this effect will increase if the depreciation of the peso is perceived to be sustained. We believe that the relative impact of this recession on other price movements will give Banxico room to maneuver and should avoid a restrictive policy in terms of real rates.
- We consider that the balance of risks is deteriorating rapidly and will continue to do so in terms of economic activity. The economy contracted by 2.7% in Q4 08, and everything points to the rate of contraction continuing in Q1 09. Sectors such as services and the previously buoyant labor market have become yet more sluggish. This suggests that the slowdown in domestic demand will be greater than expected. Because of this, we believe that the room for easing monetary policy continues to be ample, and that the Central Bank will in this context respond with cuts in the bank lending rate in the following months. The cuts will increase to the extent that the volatility of the peso decreases. If the appreciation of the peso in recent days (over 5%) appears to be consolidated, and if the peso maintains this trend next week, a cut of 50 bp on Friday would not be out of the question. If the appreciation of the peso in recent days (over 5%) appears to be consolidated, and if the peso maintains this trend next week, a cut of 50 bp on Friday would not be out of the question. We continue to anticipate that the reference rate will fall by at least an additional 150 bp.